No. 87-303

Supreme Court, U.S.
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Supreme Court of the United States

OCTOBER TERM, 1987

DOCUTEL/OLIVETTI CORPORATION, ING. C. OLIVETTI & C., S.p.A., CARLO DEBENEDETTI, EMMETT R. DEMOSS, JR., SIMONE FUBINI, B. J. MEREDITH AND ELSERINO M. PIOL,

Petitioners,

—v.—

HANNAH FINKEL,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITIONERS' REPLY BRIEF

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PETITIONERS' REPLY BRIEF

I. FRAUD ON THE MARKET THEORY DOES NOT "PRESUME" RELIANCE; IT ELIMINATES IT

Respondent's brief in opposition emphasizes petitioners' main point: "fraud on the market theory" does not "presume" reliance, it eliminates it as an element of the Rule 10b-5 cause of action.[1] Respondent states that "[t]he fraud on the market doctrine . . . permits a plaintiff to rely upon the integrity of the market . . . without pleading individual reliance upon specific misrepresentations." Respondent's Brief in Opposition ("Respondent's Brief"), p. 6. In other words, the fraud on the

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1 For the list of the corporate petitioners' parents, subsidiaries and affiliates required by Supreme Court Rule 28.1, see pages 33a-35a of the Appendix to the Petition for Certiorari filed in this Court on August 21, 1987 (the "Petition").

market plaintiff need not prove that he or she was induced to act by the defendant's conduct.

Significantly, the fraud-on-the-market-theory defendant's right to "rebut" the so-called "presumption of reliance" has nothing to do with proving that the plaintiff was *not* induced to act by the defendant's conduct. The only way for the defendant to rebut this "presumed reliance" is to show either (1) that the alleged fraud did not affect the security's market price (in which event there is no cause of action, as there are no damages), or (2) that even if the plaintiff had known of the fraud, he or she would have been willing to pay an inflated price for the security. *See, e.g., Finkel v. Docutel/Olivetti Corp.*, 817 F.2d 357, 364-65 (5th Cir. 1987).

A defendant thus cannot rebut "reliance" by showing that the misleading information had no effect on the plaintiff's decision to buy, because what induced her decision to buy is irrelevant. Indeed, Mrs. Finkel would have bought Docutel stock no matter what the stated values of the inventories were, since she ignored all information about the company, including its inventory values and earnings. She knew nothing at all about the stock, except the price at which she bought it.[2] The only way to rebut Mrs. Finkel's "reliance" would be for her to state: "I would have bought knowing that the price was fraudulently inflated." Not only will this never happen, it also

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2 Fraud on the market theory radically alters the materiality requirement as well as the reliance requirement. Since, under the theory, the "reasonable investor" need not know anything about a stock, it is impossible to determine whether any information about a stock would be material to this investor. The only person whose judgment matters is the hypothetical "market professional" who, it is assumed, actually relies on information about a company. *See* Pickholz and Horahan, *The SEC's Version of the Efficient Market Theory and Its Impact on Securities Law Liabilities*, 39 Wash. & Lee L. Rev. 943, 960-61 (1982) (logic of fraud on the market theory dictates replacing the "reasonable investor" standard of materiality with a "professional investor" standard). Thus, under the guise of increasing individual investor confidence in the market, the fraud on the market theory makes the individual investor irrelevant. There is nothing in the history of the securities laws to suggest that Congress intended such a result.

does not logically test whether Mrs. Finkel's decision to invest was *induced* by the petitioners' alleged misrepresentations.

There is absolutely no connection between petitioners' alleged conduct and respondent's reasons for buying Docutel stock. If respondent has nevertheless stated a claim for relief under Section 10(b) and Rule 10b-5, then the reliance requirement is dead.

II. FRAUD ON THE MARKET THEORY IS INCONSISTENT WITH CONGRESSIONAL INTENT IN CREATING SECTION 10(b)

Recognizing that fraud on the market theory means the end of reliance, respondent argues that reliance is an anachronism. She states that its elimination actually furthers congressional intent in the securities laws. Respondent's Brief, pp. 9-16. In fact, the elimination of reliance runs directly counter to congressional intent. Congress established a careful balance in the securities laws. *See* Petition, pp. 11-12. Congress expressly required a plaintiff to prove both individual reliance on the alleged fraud as well as the fraud's impact on a security's market price under Section 18(a)—the closest analogue to the implied action under Section 10(b).[3] *See* Black *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C. L. Rev. 435, 465 (1984).

Respondent also ignores Section 10(b)'s explicit reference to "deception," which traditionally requires proof of reliance. She focuses instead on the Section's prohibition of "manipulation." This Court has held that manipulation is virtually a term of art in the securities field, generally referring to practices such as "wash sales," "matched orders" or "rigged prices." *See Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977).

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3 The similarities between Section 18(a) and Section 10(b) provide significant insight into the proper contours of the implied Section 10(b) action. Two sections of a statute adopted at the same time should be construed as part of a unified whole.

This is not a manipulation case. It is a deception case, as are almost all fraud on the market cases. This case involves nothing but alleged misstatements of Docutel's inventory and earnings. *See* Petition, pp. 16-18; *see also* Respondent's Brief, pp. 15, 18 (complaint alleges that defendants disseminated "fraudulent information" and "misrepresentations"). Deceit, like manipulation, had commonly accepted elements that Congress undoubtedly knew. Reliance was one of those elements. Courts should not be permitted to use fraud on the market theory to remove that reliance requirement from Section 10(b).

Finally, respondent argues that maintaining the reliance requirement will frustrate recoveries except for sophisticated investors ~~who can~~ digest every disclosure made by a company, and that it will mean the end of securities class actions. Respondent's Brief, pp. 11-14. She is mistaken.

First, 10b-5's reliance requirement does not mean that every investor must read all publicly available information about a company. It simply means that the allegedly fraudulent information that is the basis of the lawsuit must have affected the plaintiff's investment decision.[4] This requirement can be easily met. Even the most complicated financial statement boils down to a company's earnings. Respondent could easily have satisfied the reliance requirement if her decision to purchase had been based on Docutel's allegedly inflated earnings. All she had to do was read the business section of one of the many newspapers that report companies' earnings on a regular basis. Yet she cannot make even this most minimal showing; she did not bother to do *any* examination of Docutel's financial performance. Permitting such a wilfully ignorant plaintiff to

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4 Interestingly, the facts of the case that respondent holds up as the Second Circuit's adoption of fraud on the market theory, *Panzier v. Wolf*, 663 F.2d 365 (2d Cir. 1981), *vacated as moot*, 459 U.S. 1102 (1982), support the view that the plaintiff had satisfied the traditional reliance requirement. The plaintiff had relied on a Wall Street Journal article and the advice of her broker, both of which were allegedly tainted by the fraud, in making her investment decision. Thus reliance or "transaction casusation" was present. *See* 663 F.2d at 367; *see also* Note, *The Fraud-On-The-Market Theory*, 95 Harv. L. Rev. 1143, 1151 n.34 (1982).

recover exemplifies how fraud on the market theory has turned Rule 10b-5 into a scheme of "investors' insurance."

Second, respondent's concern about the demise of Rule 10b-5 class actions is misplaced. The district court may still certify classes as to common issues of materiality, scienter, and market impact. Individual issues such as proving a purchase or sale and damages will always exist. It is no more inefficient or costly to the judicial system for plaintiffs to demonstrate individual reliance at the same time. The reliance requirement will of course deny recovery to those who cannot establish reliance, but this is true of any limitation on a cause of action short of absolute liability. Congress clearly intended to limit the class of plaintiffs who could sue under the securities laws. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 741 (1975).[5] The reliance requirement, like the purchaser/seller requirement and the scienter requirement, reflects the balance Congress intended to strike between the rights of securities law plaintiffs and defendants.

III. THE SUPREME COURT CASES ON RELIANCE CITED BY RESPONDENT ARE INAPPOSITE TO THIS CASE

Respondent cites *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970) and *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972) as examples of this Court's recognition that, under certain circumstances, causation in a securities fraud suit may be established by proof of materiality, without direct proof of individual reliance. Respondent's Brief, pp. 16-18. What respondent fails to perceive is that those "circumstances" are inapposite to this case.

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5 The fact that the Securities and Exchange Commission has incorporated the "efficient markets hypothesis" ("EMH") into its disclosure rules, does not mean that the EMH and fraud on the market theory should be applied to change the elements of a private cause of action under Rule 10b-5. The reliance element reflects a congressional determination on the proper scope of liability. *See* Petition at p. 12.

Mills and *Affiliated Ute* are both pure "omissions" cases. This Court held that in such cases the difficulty of proving reliance on a non-event should not preclude a plaintiff from recovery. *See Piper v. Chris-Craft Indus. Inc.*, 430 U.S. 1, 50-51 (1977) (Blackmun, J., concurring) (discussing the *Mills-Affiliated Ute Citizens* presumption of reliance). *See also* Fischel, *Use of Modern Finance Theory In Securities Fraud Cases Involving Actively Traded Securities*, 38 Bus. Law. 1, 7-8 (1982) ("It is this difficulty of proof, rather than any conceptual difficulty with the [reliance] requirement itself, that eliminates the need for proof of reliance in omissions cases.").

Mills and *Affiliated Ute* thus provide no support for eliminating the reliance requirement where there is no logical difficulty in proving reliance. Here, the complaint is based entirely on alleged misstatements of Docutel's inventory and earnings in SEC filings and the Wall Street Journal. *See* Respondent's Brief, p. 15. Respondent faces no logical difficulty in proving reliance; under *Mills* and *Affiliated Ute*, she should be required to do so.

IV. THE DIFFERENCES BETWEEN *BASIC INC.* AND THE PRESENT CASE UNDERSCORE THE DESIRABILITY OF ALSO GRANTING THE PETITION IN THIS CASE

Respondent argues that the present case differs from *Basic Inc. v. Levinson*, No. 86-279, now scheduled for oral argument before this Court on November 2, 1987, and that therefore this case should not be heard as a companion to *Basic Inc.*, Respondent's Brief, pp. 20-21. Petitioners have argued, however, that it is *because* the cases are different that this Court should also grant their petition. For the reasons enumerated in the petition and reiterated in respondent's brief in opposition, this case represents a superior vehicle for resolving the controversy over the fraud on the market theory. If scheduling problems make it impossible to hear this case along with *Basic Inc.*, this Court should hear this case on its own timetable. Only in this case is this Court presented with a pure question of

law: is reliance an essential element of a claim for relief under Section 10(b) of the 1934 Act and SEC Rule 10b-5?

CONCLUSION

For all of the foregoing reasons, the writ should issue.

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